



**DANTER
COMPANY**

Apartment Resources

A Real Estate Research Periodical

Apartment Resources is a monthly publication designed for apartment developers, lenders and builders involved in all forms of multifamily housing.

Volume 8 Number 2 March 1993

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The first installment of "Ask the Editor" details the differences between market feasibility studies and appraisals, and some key differences in methodology.

What is Real Estate Research, Anyway? Market Feasibility and Appraisals

by Greg Grant, Editor

Often, we receive a phone call from someone who has been given a copy of *Apartment Resources* by a friend or professional acquaintance. Usually, these callers will ask us to describe what we do as a “real estate research” company.

It’s a question we answer almost daily. In fact, because of the volume of questions we receive on such a variety of topics within the multifamily industry, we are starting a feature called “**Ask The Editor.**” A question and answer format will be used to tackle some of the questions we receive regularly from **Apartment Resources** readers, clients, and other multifamily professionals that we encounter.

Q: What is Real Estate Research?

The broad answer is that real estate research is the process of gathering and analyzing data on real estate values and market trends. Within this broad category are several subcategories of research with different purposes and methodologies. The two most prevalent types of real estate research are appraisals and market feasibility studies. Other types of real estate research include rent and vacancy surveys, tenant or homebuyer preference surveys, and studies of zoning laws and trends.

The Danter Company emphasizes real estate research because we conduct several types of studies, including area apartment rent and vacancy surveys, tracking of single-family and condominium starts for certain areas, and surveys tracking tenant and shopper preferences. However, these studies were developed to help us do our main line of business more effectively: market feasibility studies.

Q: What is the Difference Between an Appraisal and a Market Feasibility Study?

The difference can best be illustrated by the following comparison. The major question answered by a market feasibility study is “If I build it, will they come?”

The appraisal is designed to answer the question, “What will it be worth?” The appraisal is an estimate of the value of a property as of a certain date, while a market feasibility study measures expected market response. Because they measure different aspects of the market, each type of study needs a different methodology.

Q: How Does an Appraisal Work?

First, an appraiser, in conjunction with the client, will determine the purpose of the appraisal, which is expressed in a statement of purpose.

The purpose of most appraisals is to determine “market value” for the purpose of buying, selling, improving, or financing a project. As defined by the American Institute of Real Estate Appraisers in *Appraisal Terminology and Handbook*, market value is “the price at which a willing seller would sell and a willing buyer would buy, neither being under abnormal pressure.”

Besides market value, an appraisal may also be undertaken to identify insurable value, condemnation value, liquidation value, or assessed value.

An appraiser generally uses three approaches to help determine the appropriate value, according to *The Appraisal of Real Estate* by the American Institute of Real Estate Appraisers: the cost approach, the income approach, and the market approach. Most appraisals will determine a value of a property using all three approaches and then establish a final value by carefully considering the purposes of the appraisal and the limitations inherent in each of the approaches.

The cost approach involves identifying the replacement cost of a project minus depreciation.

The income approach identifies the value which a property’s net earning power will support.

The market data approach is based on the sales of comparable properties. Each transaction selected is studied for its sales/asking price, the conditions influencing the sale, and the differences between the properties involved that would influence the value of the property being appraised.

An appraiser goes through considerable training to make these value judgments, and appraisers who are members of the American Institute of Real Estate Appraisers (or other appraisal organizations) are held to a professional code of ethics and standards.

Appraisals are important in the development process because they set value within the financing and acquisition process. No real estate transaction should take place without an appraisal to set appropriate values.

Q: How Does a Market Feasibility Study Work?

A market feasibility study is designed to determine the depth and condition of a particular real estate market and its ability to support a particular development.

The key concern of a market feasibility study for multifamily development is a project's ultimate marketability. Therefore, the market feasibility study must determine the following:

- 1) What is the current condition of the market?
- 2) How will the market respond to the proposed project?

Determining Market Condition

To determine current market condition, The Danter Company has developed several key methodologies which work together to give us a clear picture of any multifamily market. The most important of these methodologies are the **Effective Market AreaSM (EMA)** and the **100% Data Base**.

The first step is defining the extent of the market area, because not all market areas are alike. Several basic methods exist for determining the appropriate market area.

One common method is radial analysis. In this method, a series of concentric circles is drawn around the site at, for example, distances of 3, 5, and 10 miles. The areas within these circles are then analyzed. This method is

usually employed for one reason—it is easy.

A second method, particularly common in studies for governmental bodies, is to base market areas on boundaries between governmental units. In such a method, county, township or city boundaries might become the boundaries of the market area. This, too, is an easy solution since most secondary data are reported by political delineations.

A third methodology, developed by the Danter Company, is the **Effective Market Area**. The EMA is defined as the smallest geographical area from which a project can expect to generate 60% to 70% of its support. It is not as easy, but we think it gives us a better reading of the true market area for a project.

When we determine an EMA for a project, we look at several factors, including geography, demographic analysis, mobility patterns, and area perceptions.

Geographical factors—rivers, railroads, freeways, hills, and major arteries often define neighborhood boundaries. Such geographical factors, which can play a big part in where people move, are ignored in radial analyses. In addition, geographical factors can often be more important than governmental boundaries, as market areas often cross county, township, or city borders.

Demographic factors--population and household trends, housing and income characteristics, differences in socioeconomic makeup of individual neighborhoods, and growth figures all are analyzed to help identify the EMA. Radial analyses cannot take all these characteristics into account, and often can skew a report by including neighborhoods of vastly differing socioeconomic makeup, as can analyses based on governmental boundaries.

Three Ways to Determine Market Area

1. Radial analysis—examining the area within a set geographical distance from the site. Common distances used are 3, 5, and 10 miles. This methodology cannot account for neighborhood tendencies, existing mobility patterns and natural barriers or boundaries.

2. Governmental boundaries—examines households residing within set geographical boundaries of a governmental unit, often a city, township, or county. This methodology, often required by government agencies such as FmHa and state housing finance agencies, also often fails to account for existing mobility patterns, neighborhood tendencies, and natural barriers or boundaries.

3. Effective Market Area—The EMA, designed to identify the area from which a project will receive 60% to 70% of its support, is based on four criteria: geography, demographic factors, mobility patterns, and area perceptions. All of these factors combine to help us determine the most accurate market area from which a project can expect its support.

Mobility factors—interviews with area real estate professional and civic officials are combined with our past experience in determining mobility patterns. Mobility patterns within an area are predictable, and while individuals occasionally act counter to prevailing trends, mobility analysis can help pinpoint where the majority of tenants for a particular project are the most likely to come from. Radial analyses cannot make these distinctions.

Area perceptions—we conduct interviews with area officials and real estate professionals to determine area perceptions and how they relate to the previous factors. Area perceptions are important in helping determine mobility patterns, a key component of any market feasibility study.

Our research indicates tenants already living in an apartment within the EMA are the largest single component of support for an apartment project. Typically, an apartment project can expect between 45% and 50% of its tenants from other apartments within the EMA. Add support from within the EMA from new household formation, current home owners, or other rental properties, and the total EMA support increases to 60% to 70%, depending on the demographics of the EMA.

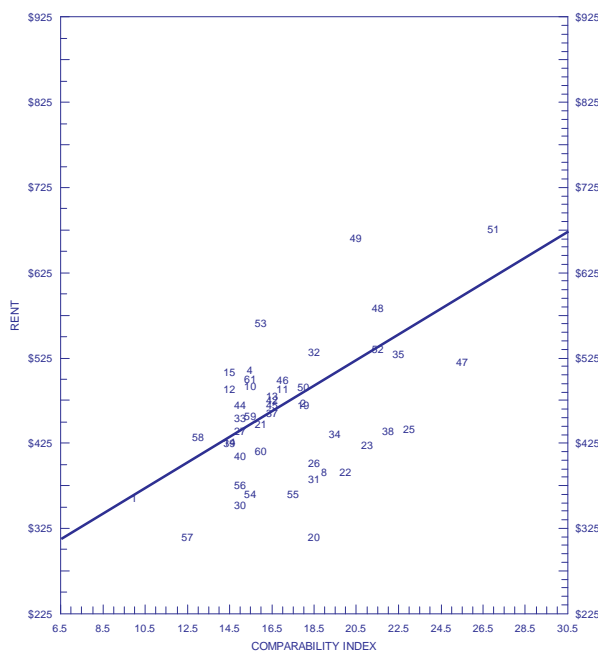
As a result, our EMA is a Supportive EMA and not a Competitive EMA. A Competitive EMA would consist of the projects most likely to compete with a proposed project for support. Therefore, a Competitive EMA is likely to include projects with a similar price point or amenity level to the proposed project, or perhaps even projects from outside the Supportive EMA. However, since the Competitive EMA includes only similar projects, it is only a subset of the Supportive EMA. Analyses using a Competitive EMA only examine a portion of the market at one pricing level, and then perhaps not all similar projects.

The 100% Data Base

The solution is the **100% Data Base**. In order to determine the depth of support for new development, it is crucial to identify support at all levels. We have found that in most markets a continuum of housing exists, starting with entry-level units, and moving to upscale units as units include more amenities and higher rents. Tenants tend to move up the continuum as their financial status increases, or as their space needs change through marriage, children, or other status changes.

FIGURE 1

DISTRIBUTION OF TWO-BEDROOM UNITS BY NET RENT AND AMENITY INDEX



The Regression Analysis

Once each project is surveyed to determine its rent and amenities, we convert those amenities into an Amenity Index, which has three components: unit amenities, project amenities, and curbside appeal (aesthetic amenities).

Rents are converted to net rents, and each project is plotted onto a scatter graph, as illustrated on the left. The regression line indicates the average market-driven rent by amenity level.

Once the regression line is established, we can establish the appropriate rent for a proposed project by using the regression line. For a project to be considered a value in the market, the rent should be positioned below the regression line. An analysis of selected comparables alone cannot position rents with the same degree of accuracy.

We also use the regression analysis extensively in our market repositioning (strategic rehabilitation) studies. Often, problem projects have rents that are far higher than market-driven rent for their amenity level. (See “The Three Types of Project Rehabilitation” in *Apartment Resources*, November 1990.)

Therefore, our field surveys identify all modern apartment developments within the EMA to determine the depth of the market at all levels. Each project is surveyed to determine rents, vacancies, amenity level and curbside appeal. Because the EMA is supportive, the field survey details the existing market conditions experienced by those tenants most likely to move into the proposed project.

Once the field survey is complete, we can then determine the condition of the market and historical trends. Our analysis identifies the number of market-rate and government subsidized units in the market and the vacancy rates by unit type (i.e., studio, one-bedroom). We also identify historic construction trends by tracking the year of construction for each modern apartment development, and the vacancy rates by year of construction. As a result, we can identify whether vacancies in the market are related to the age of the product.

Also included is a distribution of rents and vacancies by unit type. Using this distribution, we can determine how one- bedroom or two-bedroom units are performing at any given pricing level. We can also identify price points in which opportunities for development exist.

Another analysis that is key to our eventual conclusions is the regression analysis. Each apartment is rated based on its existing amenities and curbside appeal, with point values assigned to each amenity. These factors are combined to create a project's **Amenity Index**. Using this Amenity Index, we can plot each project by rent and Amenity Index to determine market-driven rents at any amenity level (see Figure 1 on Page 4). This regression analysis plays a key role in determining the supportability of a project.

The 100% Data Base gives us the ability to have expertise in every market we study. As a result, we can combine our interviews with "local experts" with the documented facts to provide a complete picture of a market at all levels based on primary information. Also, the 100% Data Base process is the easiest for a reader to follow, because the data are presented in full.

Determining Market Response

Once we have determined the condition of the market, we can then determine how the market will respond to the proposed project. In order to do that,

we combine the full market data provided by our field study with our experience studying a variety of markets.

The key result of any market feasibility study is the absorption rate. The absorption rate is the measure of how many apartments we think the project will be able to lease after opening on a monthly basis. To determine the absorption rate, we look at many factors, the most critical of which are step-up and step-down support and a rent/value analysis.

Step-up/down Support

As explained earlier, our research has indicated that the largest component of support for new modern apartment development comes from existing apartment development. Our 100% Data Base allows us to quantify this support using an analysis of step-up and step-down support.

Our research indicates that apartment tenants are willing to pay more, or "step up" their rents, for an apartment that they consider to be a value. The level of step-up support varies with different markets and the amenity level of the development. Tenants at the high end of the market may step up their monthly rent as much as \$100, but most tenants are only willing to step up their rent up to \$60.

We identify the number of units in the market with rents up to \$60 below the proposed rents for the subject site. This enables us to determine the depth of the step-

The Amenity Index

The Danter Company has developed a uniform rating system for evaluating the competitive level of an apartment project. This system produces an Amenity Index, which is used in our regression analysis to determine market-driven rent and to set appropriate rents for proposed developments.

The system is based on rating projects on a standard scale (1 to 10) based on unit amenities, project amenities, and aesthetic amenities (curbside appeal).

Each potential unit and project amenity has been assigned a point value. These point values are totaled to determine the unit and project amenities total.

The curbside appeal is determined by our field analysts based on the condition of the project. Projects that score highest in this area have extensive and quality landscaping, well-maintained buildings, and neat grounds where trash, parking, and common areas are well-maintained.

up support. Then, we compare the number of proposed units to the units of step-up support, and express this as a percentage. If this percentage is low (a small number of proposed units and a large number of units in the step-up support base), then this is reflected in a higher expected absorption rate. Naturally, an analysis of the competition's level of step-up support is also critical.

Rent/Value Analysis

A second important consideration in determining the projected absorption rate is the rent/value analysis. The regression analysis is used to determine the market-driven rent for a project at any amenity level. Using this graph, we are able to determine the relative value of the proposed units. The relative value of the project is then reflected in our projected absorption rate.

Often, based on the rent/value analysis, the step-up support analysis, an examination of competitive projects, and our own experience, we recommend changes in a project that will make it more responsive to the market (and thus more profitable, increasing rent and absorption and decreasing turnover).

For example, we sometimes recommend rent adjustments to make a project more of a value, or to place it within a market niche experiencing less competition. We also review amenity packages and suggest ways the amenity package can be fine-tuned to respond to the market and give a project competitive advantage. Also, we often review site plans to help identify premiums for which a renter will pay more (i.e., views, end-units, fireplaces, garages, carports).

We believe that the market study should be one of the most important steps in the development process. A market feasibility study not only predicts the absorption rate, but can also present methods of fine-tuning the product to achieve greater success in the market. In addition, our policy of continued consulting until project finalization ensures that the market impact of all changes is fully evaluated and documented.

Q: Why Doesn't The Danter Company Use Selected Comparables for Market Feasibility?

We realize many companies continue to use selected comparables for market feasibility. Selected comparables are appropriate as one approach for determining market value, but they do not determine

market support. This is the primary reason that we have developed a fully documentable methodology specifically for determining market feasibility. When applied to market feasibility, the methodology of selected comparables has several flaws.

First, the Danter Company method identifies the market status at all pricing and amenity levels. Selected comparables can only examine the market at certain price or amenity levels, and then only with a sample.

Second, many markets are filled with larger, older projects that are functionally obsolete, having little closet or storage space, small bedrooms, and generally lacking modern floor plans and design features. The performance of these projects cannot be compared with any accuracy with the potential performance of a well-designed project with modern design.

Third, poor selection of selected comparables can give a false picture of the market, making it subject to sampling errors. If one or two of the selected comparables are poorly managed in a good market, it can look as if the whole market were performing poorly. Conversely, well-managed selected comparables in a poorly-performing market can make a market seem better than it is.

Fourth, often selected comparables from outside a project's EMA are used. Using such projects is misleading because they draw from a different tenant base with different socioeconomic characteristics. What works on the east side of town might not work on the west side, and poorly chosen selected comparables give a false picture.

Any Questions?

We hope this article has given some helpful insight into what we do at The Danter Company. If you have any questions about real estate research, or more specifically about any facet of apartment development or marketing, please give us a call at 1-800-532-6837 or fax us at (614) 221-4271. The best questions will be used in a future installment of "Ask The Editor."